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Market Update: 1st Quarter (2016)

After sharp losses to begin the new-year, stocks finished the quarter slightly ahead thanks to a rebound in oil prices and stimulative monetary policy. The S&P 500 ended the quarter up 0.8%, while oil prices surged 40% from their lows at the start of the year. (Oil prices are still off 60% from highs reached in June of 2014.) Global equities declined 11% through February 11 … and then soared 13% to end the quarter.

> **It's been a roller-coaster ride, and some investors have been whipsawed. If you came into the year bullish, you got off to a very rough start; if you lost heart in January or February, you're kicking yourself now because of the recovery.**
>
> **David Donabedian, Atlantic Trust Wealth Mgt – WSJ (3/31/16)**

> **The thing about a roller-coaster is that you get off at the same place as you got on, but you might feel queasy after the ride.**
>
> **Randall W. Forsyth – Barron's (4/4/16)**

Global economic growth remains sluggish and conditions soft. S&P 500 companies are expected to see declining first quarter earnings (down 8.5% in comparison to the same period last year). This would be the fourth quarterly decline in a row. Profits are expected to rebound in the second half of 2016, partly due to favorable comparisons to the prior year periods.

Earnings declines have further stretched valuations. According to FactSet, the S&P 500's trailing price/earnings ratio is 18.2 - well above the 15.8 average over the past ten years.

Still, stocks look good relative to bonds. Fifteen years ago, S&P 500 stocks had a dividend yield of about 1.5% when the 10-year treasury had a 5% yield. Today stocks have a higher yield (2.3%) than 10-year treasuries.

U.S. gross domestic product (GDP) was revised upward to an annualized rate of 1.4% for the fourth quarter of 2015. Our economy appears to be advancing at an even slower pace during the first few months of 2016, with early estimates at or around 1 percent. Apparently, people are saving more than spending.

It's not a polar vortex winter. You can't blame the weather this year. It's the consumer. It's not falling off the cliff. We're not in a recession, but it's consistent with worry.

Diane Swonk, DS Economics – CNBC (3/28/16)

Consumers should feel good about solid employment growth, cheap gas prices and a rebounding housing market. The March jobs report (released on April 1) showed continuing improvement. Wage growth is rising (up 2.3%), and more people are entering the workforce. The labor participation rate reached 63% in March, its highest level in 2 years.

On the other hand, employee compensation relative to GDP is at historical lows, and corporate profits are at their highest ever levels. This may be at the heart of what is influencing anti-establishment politics.

Bonds/Interest Rates:

As the new-year began, it seemed certain that interest rates would rise and the dollar would continue to strengthen. The exact opposite occurred. The dollar declined to a five-month low, and the 10-year Treasury ended the quarter at 1.784% … down from 2.273% at the end of 2015.

If unemployment is down and wages are on the rise, is inflation inevitable? If so, how does that reconcile with declining interest rates?

It is hard to figure out what is really going on with the disconnect between data and the bond market. Am I missing something?

David Coard, Williams Capital Group – WSJ (3/31/16)

One reason: Negative interest rates in Japan and Europe are increasing demand for U.S. bonds. So, as the Fed increases short-term rates, long-term rates could hold steady or decline due to global economic forces.

After the quarter-point increase in December, the Fed initially committed to four quarter-point increases in 2016. Recent stock market volatility and economic uncertainty have changed that expectation to two quarter-point increases at most. Stay tuned.

China:

Both Standard and Poor's Ratings Services and Moody's Investors Service recently lowered their outlook on China's sovereign debt. They cited increasing economic and financial risks … and that efforts to rebalance the economy (away from investments/exports and toward domestic consumers/technology) are going slower than expected.

> **It's just a confirmation of what's known about China: The fact that growth is slowing down, and total debt in the system is increasing.**
>
> **Binay Chandgothia, Principal Global Investors – WSJ (3/31/16)**

It's difficult to maintain currency stability while simultaneously providing liquidity to a softening economy and a strained banking system. *Banking sector problems can lead to currency crashes.* It should come as no surprise that getting money out of China is becoming a priority for many individuals and corporations.

> **Chinese policymakers are pursuing two goals that will almost certainly turn out to be incompatible.**
>
> **Carmen Reinhart, Harvard University – (3/22/16)**

Just like Japan, China has run up huge debts. Corporate debt was recently measured at 160% of GDP, up from 98% in 2008. By comparison, U.S. companies carry debt at 70% of U.S. GDP.

But unlike Japan, most Chinese citizens live in poverty. After building up excess capacity in numerous industries, China will have to choose between mass layoffs or continued debt escalation.

Emerging Markets:

Emerging market (EM) equities surged 13% in March to end the quarter up nearly 6% … thanks to rising oil/commodity prices and easing monetary policy by global central banks.

However, they are not out of the woods just yet. Deteriorating credit quality is a concern, as credit-rating agencies have cut EM bond ratings to their lowest levels in more than 6 years. According to the Bank for International Settlements, debt burdens in emerging economies have increased more than 50% since 2008.

Asian markets rebounded sharply in March (up 8.2%), ending the quarter down 2.3%. Quarterly performance by country was all over the place, with China's Shanghai

Composite down 15.1% (even after an 11.8% gain in March) and Japan's Nikkei Stock Average down 12% for the quarter (after gaining 4.6% in March).

Eurozone:

The June 23 referendum will determine if the United Kingdom leaves the European Union. The potential for a British exit … or Brexit … and the political/economic fallout are creating considerable uncertainty. Opinion polls suggest Britons will vote to remain, but the polls have narrowed recently.

In the not too distant future, state-funded pensions in Europe are going to be in serious trouble. Funding out of current tax revenue, the social welfare model is being challenged by low birthrates and high longevity. (The birthrate in Europe has fallen 40% since the 1960s, while life expectancies have risen from 69 to 80 years over the same period.)

Gold:

Gold registered its largest quarterly gain in three decades. The bulk of the gains were concentrated at the start of the new-year, as stocks slumped. But even as stocks have rebounded, gold has held on to its gains.

> **People are reluctant to take profits on their gold positions because of all the insecurity the world is facing.**
>
> **George Gero, RBC Wealth Management – WSJ (3/31/16)**

Signals by the Fed to more slowly raise interest rates have weakened the dollar, which has helped most commodities that are priced in dollars. Political uncertainty has also intensified with the potential U.K. exit from the European Union, along with questions regarding the future course of U.S. politics and policy.

Initial Public Offerings (IPOs):

Amid concerns about the economy and equity markets, IPOs had their slowest period (both in number of offerings and total money raised) since 2009. Issuers usually like to sell in rising markets … but shy away from uncertainty and volatility.

> **It's kind of unprecedented for the general stock market to be so close to record highs and yet so little IPO activity.**
>
> **Jay Ritter, Prof of Finance, Univ. of Florida – WSJ (3/31/16)**

This could also mean more declines for private technology companies with values at levels not likely to be realized in the public markets.

> **After flying too close to the sun, technology company valuations started heading toward earth as their multiples contracted. Helping that process along, mutual fund companies continue to lower valuations on the closely held tech startups in their portfolios.**
>
> **Sandra Ward – Barron's (4/4/16)**

IPO volume plummeted 74% worldwide, according to Dealogic. Global investment banking revenues are down 36% from the previous year and are at their lowest levels since 2009.

Zero-based interest rate policies (ZIRP) continue to hurt savers and investors. Approximately 65% of government bonds worldwide now yield less than 1%, with nearly half of those now yielding negative rates. *It is creating a massive problem for pension funds, not to mention the American dream of a comfortable retirement.* If rates are not normalized in the near future, pensions will not be able to meet their obligations as promised, and individuals will have to work longer, live more frugally, or die sooner … not very good choices.

> **If year upon year of ultra-low rates were enough to create an economic boom, Japan would be the world's strongest economy right now. It obviously isn't - which says something about ZIRP's efficacy as a stimulus tool.**
>
> **John Mauldin, Mauldin Economics (2/28/16)**

Overall, the world economy will continue to struggle with the 3 D's … **deficits, debt and demographics**. These problems have been building for some time, and the trajectory is simply not sustainable.

Current economic fundamentals are still solid, and the *plow horse economy* in the U.S. appears to remain on track. Stock valuations, while high relative to historical measures, still look good in relation to other asset classes. Let's hope that policy

makers get back on track with normalizing interest rates … and become more proactive in addressing the mounting global debt dilemma.

Daniel G. Corrigan, CPA/PFS, CFP®